The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether in the circumstances of this case the Commissioner of Internal Revenue abused his discretion in disallowing tax deductions to petitioner for amounts added to its bad debt reserve for the years 1963 and 1964.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 166. Bad debts.

* * * *

(c) Reserve for bad debts.

In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

* * * *

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.166-4 *Reserve for bad debts.*

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

* * * *

STATEMENT

Petitioner is a North Carolina corporation organized in 1956, and since April 1 of that year has been in the business of making loans to various North Carolina enterprises. Prospective borrowers were required to show an unsuccessful attempt to obtain the loan from a conventional banking source before they could qualify for a loan from petitioner. (R. 17, 49.)[1]

For federal tax purposes, petitioner elected to deduct bad debts by the reserve method provided in Section 166(c) of the Code, and accordingly established a "bad debt" reserve to which annual deductions were charged. From 1956 to the end of 1962, petitioner had accumulated a bad debt reserve of $318,387.58, while sustaining no actual bad debt losses. During

[1] "R." references are to the record appendix and "Ex. Vol." references are to the exhibit volume filed in the court of appeals.

1963 and 1964, petitioner incurred its first actual bad debt losses in the total net amount of $51,053.38. For these same years petitioner sought deductions for additions to its bad debt reserve in the amount of $95,000 in 1963 and $120,000 in 1964. (R. 17.)

On audit, the Commissioner determined that the balance in the reserve account at the beginning of 1963 ($318,387.58), even when reduced by the actual losses sustained in 1963 and 1964, was sufficient as a reserve against losses which petitioner could reasonably expect to sustain with respect to its loans outstanding at the end of 1963 and 1964. The deductions claimed by petitioner for the additions to the reserve for those years were accordingly disallowed.

The jury, in answer to special interrogatories, responded that the Commissioner had been arbitrary in disallowing the proposed additions for the years 1963 and 1964 and that the additions for which petitioner claimed deductions were reasonable (Pet. App. 5a-6a; R. 152-153). The trial judge denied the government's Motion for Judgment Notwithstanding the Verdict or, in the Alternative, for a New Trial (Pet. App. 3a-4a). On appeal the Fourth Circuit reversed, holding that petitioner's evidence "wholly failed to establish that the Commissioner was unreasonable or violated his discretion" (Pet. App. 4a-8a).

ARGUMENT

The decision of the court of appeals is correct. There is no conflict of decisions or other reason for further review.

1. Section 166(c) permits a taxpayer to deduct a "reasonable addition" to a reserve for bad debts in lieu of taking deductions for the debts which actually become worthless. The reserve method authorizes a deduction with respect to a taxable year for increases in the reserve necessary to provide for estimated future losses on the loans outstanding as of the close of that year, regardless of actual losses in that year. The reserve is reduced from time to time by actual losses, as they are incurred. By the express terms of the statute, the deduction for the reserve addition is allowed only in the discretion of the Commissioner.

The Regulations (Sec. 1.166-4(b)(1)) provide that the reasonableness of any proposed additions to a bad debt reserve depends primarily on the total loans outstanding as of the close of the year and the balance in the existing reserve. The balance in the existing reserve, of course, is the amount by which the bad debt deductions previously taken exceed the actual bad debt losses incurred.

The loans outstanding at the end of 1963 and [illegible] the years in question, totalled $9,332,073 and $9,552,759, respectively. During almost seven years of operations prior to 1963, petitioner sustained *no* actual bad debt losses. At the beginning of 1963, the existing reserve balance was $318,387.58. In 1963 and 1964 petitioner incurred its first actual bad debt losses, in the total net amount of $51,053.38. After reduction for the actual losses, the reserve balance as of the close of 1964 was $267,334.20, more than five times the actual losses incurred during nine years of operations and more than forty times the

average annual actual losses during this period. By the end of 1964 petitioner had been repaid some $9.3 million in loans; during its existence to that time total outstanding loans did not exceed $9.6 million (R. 19, 57; Ex. 12, Ex. Vol.).[2] In these circumstances, the Commissioner correctly disallowed the claimed tax deductions for additions to the reserve in 1963 and 1964 and plainly did not abuse his discretion in doing so.[3]

2. Petitioner contends (Pet. 7-10, 19-20) that, in determining whether the claimed reserve additions were "reasonable," the court of appeals employed improper standards and decided this issue in conflict with *Rhode Island Hospital Trust Co.* v. *Commissioner*, 29 F.2d 339 (C.A. 1). While petitioner correctly states that many factors are to be considered in determining whether a bad debt reserve addition is reasonable, the Commissioner did, in fact, consider the factors to which the Regulations attach primary importance—total loans outstanding and existing reserve balance—along with petitioner's actual loss his-

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[2] Contrary to petitioner's contention (Pet. 20), one complete cycle of loans thus had almost been completed.

[3] Petitioner complains (Pet. 6, 17-19) that its reserve balance, without the additions claimed for 1963 and 1964, was only 3.1 percent and 2.8 percent of its outstanding loans at the close of the respective years. We note that petitioner's average annual ratio of actual bad debt losses to outstanding loans at the close of each year during the twelve years of operations completed at the time of trial was approximately .05 percent (R. 17, 19). The obvious leeway thus present in the reserve, without the claimed additions, fully supports the Commissioner's disallowance.

tory.[4] These are the very factors which petitioner's authorities say must be considered.

Petitioner apparently overlooks that *Rhode Island* turned on the particular factual setting in which it arose, and which, on analysis, is readily distinguishable from the present case. There the court placed great emphasis on the unusual economic conditions existing at the time and stated that such called for "unusual measures" and justified a departure from actual loss experience in determining a reasonable reserve addition for the year in question. No such similar circumstances exist with respect to the case at bar.

3. Petitioner further contends (a) that the diversity of the court decisions dealing with deductions allowable for additions to bad debt reserves renders Section 166(c) meaningless (Pet. 10), and (b) that the Commissioner applied a "double standard" in denying the deductions here claimed (Pet. 17). In so doing petitioner fails to recognize that it had the burden of proving, by facts relevant to its own loan

[4] The taxpayer's actual bad debt loss experience is of vital importance in determining the propriety of deductions claimed for additions to a bad debt reserve. See *United States* v. *Haskel Engineering & Supply Co.*, 380 F. 2d 786 (C.A. 9); *Patterson* v. *Pizitz, Inc.*, 353 F. 2d 267 (C.A. 5), certiorari denied, 383 U.S. 910; *Massachusetts Business Development Corp.* v. *Commissioner*, 52 T.C. 946. We also note that for taxable years beginning after July 11, 1969, Congress has adopted the actual loss experience test for Small Business Investment Companies and business development corporations (such as petitioner). Section 586 of the Code, added by the Tax Reform Act of 1969, restricts bad debt reserve additions, and thus tax deductions based thereon, essentially to the amount called for by actual loss experience.

portfolio, that the Commissioner abused his discretion in denying the claimed deductions because petitioner's existing reserve was sufficient to absorb prospective losses with respect to its outstanding loans. Of course, the essentially factual nature of the Commissioner's determination can be expected to result, and has in fact resulted, in decisions which can only be reconciled on the basis of the peculiar circumstances on which they are grounded. But certainly this does not make the statute, or the test applied thereunder, "meaningless." Petitioner's reliance on revenue rulings issued with respect to other taxpayers in other circumstances is similarly misplaced.[5]

4. The petition asserts (Pet. 14) that the court of appeals decision deprived petitioner of its Seventh Amendment right to jury trial. But petitioner failed to carry its burden of demonstrating an abuse of dis-

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[5] Petitioner challenges (Pet. 20) the Commissioner's disallowance here as inconsistent with his treatment of other taxpayers. The short answer is that the Commissioner is not required to treat petitioner in the same fashion he has treated other types of taxpayers in differing circumstances.

Thus in Revenue Ruling 65-92, 1965-1 Cum. Bull. 112, the Service sought to minimize the existing large variations in permissible reserves of banks. It referred to special circumstances in the banking industry, and specifically stated that the method would not be used as a precedent for determining reasonable additions to reserves for bad debts for taxpayers other than banks.

Rev. Rul. 64-48, 1964-1 Cum. Bull. (Part 1) 104, dealing with Small Business Investment Companies, is likewise inapplicable. It was issued in the absence of any loss experience by SBIC's and provides no guidance for petitioner, which is not SBIC and has an actual loss experience. See *Massachusetts Business Development Corp., supra.*

cretion by the Commissioner. The "expert" opinion evidence proffered by petitioner did not go to the pivotal question of what losses could be reasonably anticipated with respect to petitioner's outstanding loans as of the close of 1963 and 1964. As the court of appeals found, there was no substantial evidence to support the jury's finding of abuse of discretion, because the inference necessary to support this conclusion was, from the facts petitioner presented, so tenuous as to rest merely on speculation and conjecture (Pet. App. 7a-8a). In making this determination the court applied the correct standard of appellate review and petitioner's challenge is without merit. *Manaia* v. *Potomac Electric Power Co.*, 268 F.2d 793, 798-799 (C.A. 4), certiorari denied, 361 U.S. 913.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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OCTOBER 1970.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1970 407305 272